The Money and Bond Markets in October

Short-term interest rates continued to decline in October, while yields on long-term bonds generally rose as the capital markets labored under a record $4.9 billion of corporate and tax-exempt offerings. Consequently, the yield spread in favor of interest rates on long-term issues over those on short-term obligations continued to rise in all sectors of the market. An increase in this yield spread is, of course, normal during an economic slowdown, when slack in the economy and a less restrictive monetary policy foster a more rapid decline in short-term than in long-term rates. The 1970 experience has been somewhat unusual, however, because long-term interest rates reached their peaks quite late in the cycle—well after short-term rates had started trending lower—and are still close to these high levels.

A major force holding long-term rates high has been the massive outpouring of intermediate- and long-term corporate bonds. Through October, corporate bond flotations in 1970 totaled more than $24 billion, about 30 percent higher at an annual rate than in 1967, the previous record year. A number of factors seem responsible. First, some restructuring of corporate debt is normal after a period of monetary restraint, in which corporations have depended heavily on bank loans and short-term debt. Since the recent period of monetary restraint had been quite prolonged, as had corporate reliance on short-term borrowing, a surge in corporate bond flotations is perhaps not surprising. In addition, the Penn Central Transportation Company's insolvency and the ensuing weakness in the commercial paper market made many corporations anxious borrowers in the bond market without too much concern about the level of interest rates. Furthermore, corporate borrowers seem to be guarding against the possibility of a rapid rebound in the economy such as developed in 1967.

As corporations substituted borrowing in the capital market for short-term borrowing, bank lending activity remained slack in October. This enabled the banks to make substantial additions to their investment portfolios, which in turn was beneficial to the municipal bond market where bank demand played a key role in steadying prices of shorter and intermediate-term maturities. On the basis of preliminary estimates, the narrowly defined money supply—demand deposits and currency held by the public—showed a small increase in October. Time deposits continued to flow into the banking system at a very rapid pace in October, as investor interest in large certificates of deposit (CD's) was apparently undiminished by a lower range of offering rates. While these deposits expanded, member banks once again reduced their reliance on nondeposit sources of funds.

BANK RESERVES AND THE MONEY MARKET

Conditions in the money market remained comfortable through October, although a slightly firmer tone displaced the particularly easy conditions prevailing in late September. During the first week of the month, the effects of the Federal Reserve Board ruling imposing reserve requirements on funds received by banks from the sale of their affiliates' commercial paper, and the simultaneous reduction in required reserves held against certain time deposits,[1] became evident on the balance sheet of the banking system. The measures contributed to a net reduction of $408 million in required reserves during the statement week ended October 7. Although this was partially offset by System open market sales and the absorption of reserves by operating factors, member bank excess reserves rose considerably during that week. Since the high level of excess reserves was not exceeded by member bank borrowings (see Chart I), banks were in a free reserve position for the first time since February 1968. Despite ample reserve availability, the average effective Federal funds rate rose sharply during the week (see Chart II), reflecting pressure from heavy financing needs of Government securities dealers and a cautious management of reserve positions by member banks. Over the remainder of the month, conditions in the money market were comfortable, and the average effective rate on Federal funds moved somewhat lower.

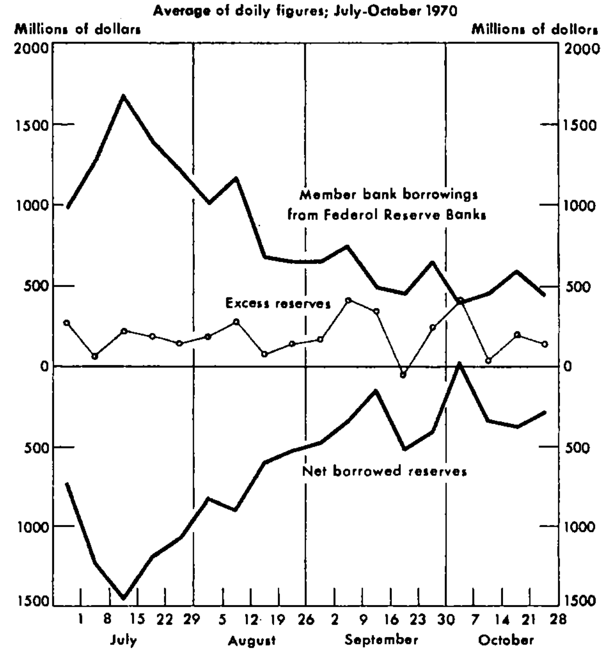
Lack of pressure on member bank reserve positions, combined with weak loan demand, led banks to reduce further their level of borrowings from the Federal Reserve Banks. Member bank borrowings declined by $138 million in October to an average of $468 million (see table), their lowest level since October 1968.

Demands for funds in the commercial paper market were moderate in October. In addition to the emphasis

Chart I

MEMBER BANK BORROWINGS AND EXCESS RESERVES

Average of daily figures; July-October 1970



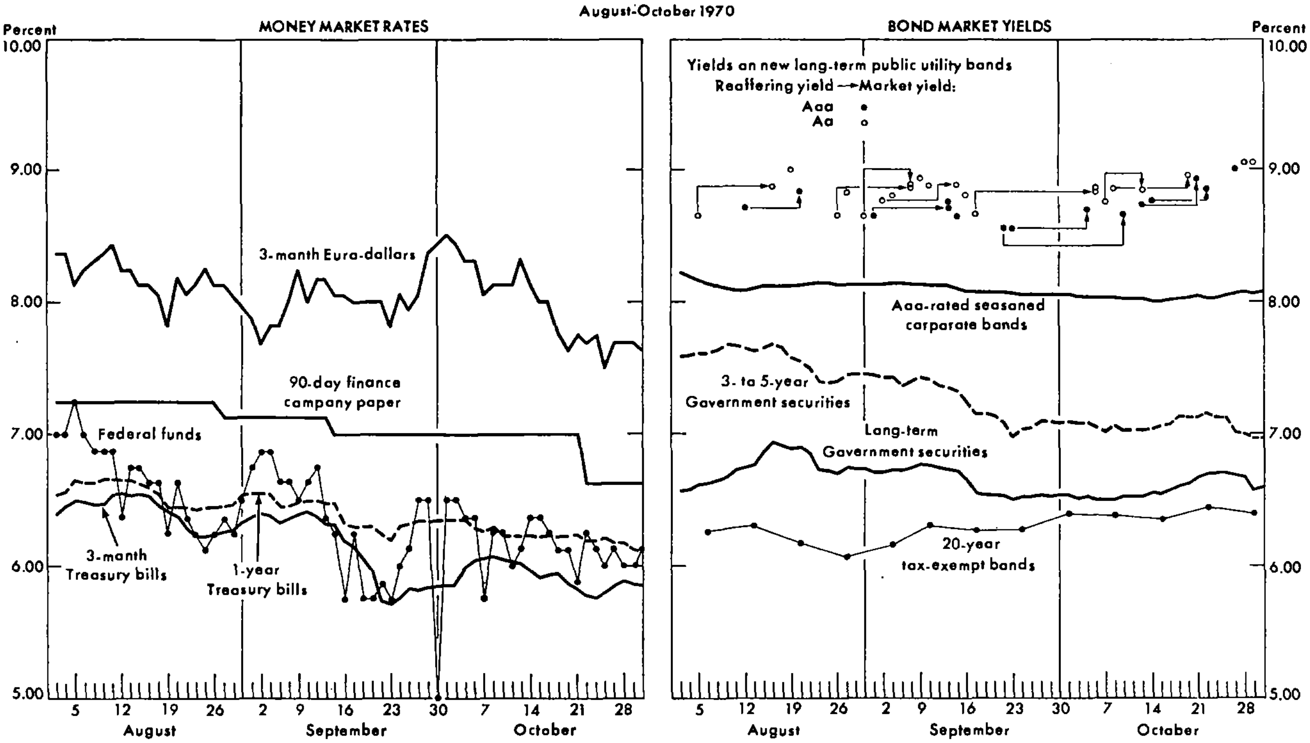
Source: Board of Governors of the Federal Reserve System.

[1] For a discussion, see this *Review* (September 1970), page 213.

Chart II

SELECTED INTEREST RATES

August-October 1970



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month and one-year Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa- and Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

on long-term financing, demand pressures were reduced as bank affiliates again allowed a substantial share of their obligations to run off at maturity. Moreover, the auto strike may have exerted a dampening effect on the growth of finance company paper by retarding auto sales. During October, interest rates on commercial paper continued to decline, as did rates on such other money market instruments as bankers' acceptances and three-month Euro-dollars.

A pronounced weakness in bank lending, which had been evident from about mid-September, continued through October. Despite the September prime rate reduction, business loan demand remained slack. The volume of commercial and industrial loans outstanding at all weekly reporting banks fell by about $1.2 billion[2] in the five weeks ended October 21, compared with sizable increases in the comparable period of the three preceding years. In the face of sluggish loan activity, banks increased their holdings of securities—particularly short- and intermediate-term obligations of state and local governments. The growth of commercial bank holdings of municipal securities thus far this year has been marked and stands in sharp contrast to the liquidation of these

[2] Includes an adjustment for loans repurchased from affiliates in connection with commercial paper redemptions.

investments, which occurred during the comparable period of 1969 when banks were attempting to meet loan demands at a time of severe disintermediation. Over the first ten months of 1970, bank holdings of obligations of states and political subdivisions increased by $4.4 billion, compared with a $2.7 billion decline during the like period last year.

Banks again received very strong inflows of time deposits in October. Despite reductions in issuing rates on large CD's during the month, the volume of these obligations outstanding continued to surge ahead as it has since the partial suspension of Regulation Q interest rate ceilings in late June. Indeed, offering rates on large CD's of 30- to 89-day maturity have fallen to or below the suspended ceiling rates. In late June, in contrast, they exceeded those ceilings by 1½ percentage points. Moreover, offering rates on longer maturities fell below the Regulation Q ceiling rates in October. This may have the effect of lengthening the average maturity of large CD's, which stood at only 2.9 months at all weekly reporting banks in September, the most recent month for which data are available. Over the four weeks ended October 28, large CD's increased by $1.25 billion, bringing the total volume outstanding to $23.50 billion.

The daily average money supply expanded at a rate of approximately 1 percent during October.[8] However, since this series frequently shows considerable month-to-month variation, longer time periods are more suitable for examining the behavior of this aggregate. Over the first ten months of the year, the rate of increase in the money supply averaged 4 percent. The adjusted bank credit proxy, a measure of member bank liabilities, also grew at about a 1 percent rate in October, as strong deposit growth was offset to a large extent by a reduction in nondeposit liabilities. This aggregate has grown at an annual rate of 7.5 percent thus far this year.

THE GOVERNMENT SECURITIES MARKET

The buoyant tone that characterized the Government securities market during most of September faded somewhat in early October, as the slightly firmer tone of the money market reduced speculation of an imminent reduction in the discount rate and tempered expectations of further sharp declines in interest rates. Activity in the market during the early days of the month was also restrained by anticipation of the October Treasury financing and uncertainty about the vehicle that might be chosen to raise the new cash. Thus, yields on intermediate- and long-term securities and Treasury bills all edged higher during early October.

[8] Because final October data are not yet available, growth rates of the money supply and adjusted bank credit proxy are based on an average of the four weeks ended October 28.

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, OCTOBER 1970

In millions of dollars; (+) denotes increase (—) decrease in excess reserves

Factors	Changes in daily averages—week ended on				Net changes
	October 7	October 14	October 21	October 28	
"Market" factors					
Member bank required reserves	+ 408	—	— 348	+440	+ 500
Operating transactions (subtotal)	— 153	— 348	+ 182	— 82	— 351
Federal Reserve float	+ 21	+ 191	+ 544	— 339	+ 417
Treasury operations*	+ 214	— 163	— 63	— 71	— 83
Gold and foreign account	— 10	— 4	+ 9	— 15	— 20
Currency outside banks	— 272	— 331	— 511	+ 407	— 707
Other Federal Reserve liabilities and capital	— 106	— 41	+ 203	— 14	+ 43
Total "market" factors	+ 255	— 348	— 166	+ 408	+ 149
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 219	— 57	+ 88	— 326	— 514
Outright holdings:					
Government securities	— 165	—	— 16	— 63	— 244
Bankers' acceptances	— 2	+ 3	— 2	—	— 1
Repurchase agreements:					
Government securities	— 18	— 56	+ 83	— 205	— 196
Bankers' acceptances	— 9	— 8	+ 7	— 14	— 24
Federal agency obligations	— 25	+ 4	+ 16	— 44	— 49
Member bank borrowings	— 265	+ 57	+ 135	— 153	— 226
Other Federal Reserve assets†	+ 380	+ 42	+ 27	+ 17	+ 466
Total	— 104	+ 41	+ 250	— 464	— 277
Excess reserves	+ 151	— 307	+ 84	— 56	— 128

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	28,777	28,470	28,902	28,406	28,639‡
Required reserves	28,354	28,354	28,702	28,262	28,418‡
Excess reserves	423	116	200	144	221‡
Borrowings	396	453	588	435	468‡
Free, or net borrowed (—), reserves	27	— 337	— 388	— 291	— 247‡
Nonborrowed reserves	28,381	28,017	28,314	27,971	28,171‡
Net carry-over, excess or deficit (—)§	149	204	69	88	128‡

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury balances at the Federal Reserve and in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended on October 28.

§ Not reflected in data above.

The upward drift in yields was halted toward the close of the first statement week by increased demand in advance of President Nixon's October 7 statement on the Vietnam situation. While market participants viewed the speech as constructive, its subsequent effect on the market was minimal since it was not considered likely to affect near-term interest rate movements. Thereafter, yields on long-term issues began to climb once again, as prices were affected by the weakness developing in the corporate sector. Shorter term notes and bonds, however, benefited from the October 8 announcement by the Treasury that it would raise \$2.5 billion in new cash via a tax anticipation bill (TAB) offering at midmonth. Since some market participants had speculated that the financing would take the form of an 18- to 24-month note and had reduced their holdings of issues in that maturity range, demand for shorter term Treasury securities was stronger in the wake of the TAB announcement. News of the offering caused only a brief hesitancy in the Treasury bill market, as participants expected that bank demand for the new issue would be good, in light of both sluggish lending activity and full tax and loan privileges accorded the offering. Improved conditions in the financial markets in recent weeks were underscored by the terms of the TAB offering. The average issuing rate on the bills was set at 5.970 percent, well below the 6.504 percent rate on the previous nine-month TAB offered in late July and the lowest on such an issue since July 1968.

Attention in the intermediate-term sector during the second half of the month was focused on the Treasury's refinancing of \$7.7 billion of notes maturing in November. On October 22 the Treasury announced that holders of the maturing securities could exchange them for either a 42-month note with a 7¼ percent return or a 7½ percent note maturing in August 1976 and priced to yield 7.39 percent. In anticipation of this announcement, prices of issues due in three to five years had eased in generally quiet trading. Prices rebounded sharply after the announcement, however, as strong interest developed in the new issues. By the close of the books on October 29, the new issues had risen to a premium of 1$\frac{9}{32}$ over issue price for the 3½-year note and 1$\frac{7}{32}$ for the note maturing in 1976. Much of the enthusiasm appeared to be based on the renewed expectation that a cut in the Federal Reserve discount rate—and perhaps a further cut in the prime lending rate—was likely over the weeks ahead. On October 30 the Treasury reported that the refunding had been highly successful, with a relatively low attrition of 12 percent. About \$5.3 billion of the \$6.0 billion in maturing notes held by the public was exchanged for the new notes. The department also announced that it plans to cover the attrition and raise new cash through the auction of \$2 billion of a 1½-year note with a 6¾ percent coupon on November 5. This will be the first time in thirty-five years that a competitive auction has been used to sell notes. The procedure has been selected by the Treasury to provide it with somewhat more flexibility in varying market circumstances.

Developments in the long-term sector during the latter half of October continued to be influenced primarily by the easing of corporate bond prices. Since many investors move between the two sectors, dealers lowered prices of long-term Treasury issues as corporate yields were rising. Prices picked up late in the month, however, when bonds attracted good buying at the higher yields. In the Treasury bill sector, moderate but steady demand from midmonth to late October caused rates to decline. Strong bank interest in the TAB auction and a relatively thin supply of short-term issues in dealers' inventories contributed to the rate improvement.

OTHER SECURITIES MARKETS

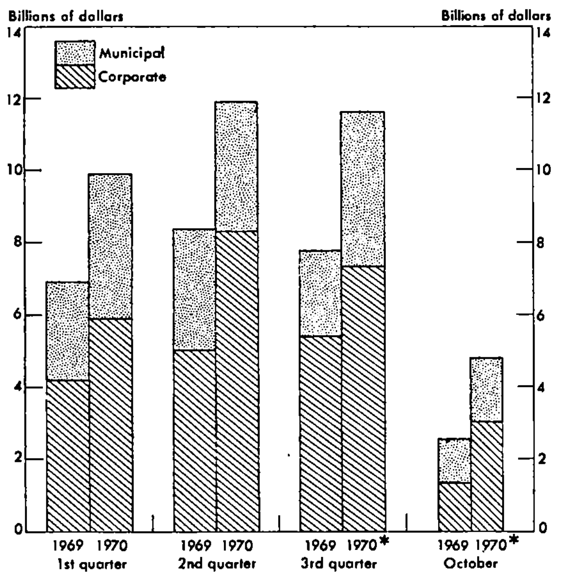
During October, total corporate and tax-exempt bond offerings were at a record volume of approximately \$4.9 billion. The month's new offerings ran about 80 percent ahead of last October, and continued the trend under way throughout 1970. In each quarter of this year, financings carried out in both the corporate and municipal bond sectors have exceeded considerably those undertaken in the corresponding periods of 1969 (see Chart III). Despite the heavy onslaught of new issues in October, the capital market displayed considerable strength, and yields were not far above their end-of-September levels by the close of the month.

A marked preference for higher quality issues, which became evident in the wake of the Penn Central insolvency, persisted through October. During the first half of the year, the spread between Baa- and Aaa-rated seasoned corporate bonds fluctuated primarily within the range of 75 to 90 basis points, and stood at 70 basis points on June 15. Following the disturbance in the nation's financial markets in late June and early July, the yield spread widened substantially, reaching 136 basis points in late August. During September and October, the spread remained close to this margin, which is the widest that has occurred in the postwar period.

In the corporate sector, where some \$3.0 billion in new debt was introduced during the month, the schedule of offerings was moderately light in early October. Prices of highly rated seasoned issues edged upward during that period, and most new issues were well received as issuing

Chart III

CORPORATE AND MUNICIPAL BOND OFFERINGS



*Estimates.

Sources: Securities and Exchange Commission, Statistical Bulletin; Board of Governors of the Federal Reserve System.

rates were set above those of late September. The higher range of offering yields caused a fairly sharp downward price adjustment on the unsold portions of several issues originally marketed in late September which were released from syndicate at this time. The yield on Pacific Northwest Telephone Company debentures offered at the end of September, for example, rose from 8.55 percent to 8.70 percent when price restrictions were removed in early October.

Favorable anticipation of the President's address on Vietnam pulled up prices of most outstanding corporate bonds and encouraged a quick sellout of several new issues. However, prices eased in the wake of the announcement as the heavy volume of new issues and mounting dealer inventories became the overriding concerns. Although some encouragement was offered at midmonth by the very good reception given to another large Bell System offering at a yield of 8.76 percent, prices continued to edge lower. In addition to the backlog of inventories, a formidable visible future supply of offerings increased pressures in the corporate sector. This was highlighted by the American Telephone and Telegraph Company's announcement on October 21 that it planned to offer $500 million in new debt in early November. Under the weight of these supply factors, new issue yields moved up steadily, and on October 27 a $150 million debt offering of Mountain States Telephone and Telegraph Company reached the market with a 9 percent yield—the highest on a Bell System issue since late June. Several syndicates were terminated, and a number of new issues postponed at this time. However, good demand generally developed at the higher yield levels, in part because of speculation about a reduction in the discount rate or prime rate.

A heavy supply of new offerings was also a major factor influencing the price of tax-exempt securities in October. The municipal sector, however, benefited from strong bank demand, which played a very important role in stabilizing prices of shorter and intermediate-term issues. Prices of longer term municipals, which were steadied early in the month by the improved expectations regarding the Far East and a good reception of new offerings, gained ground toward midmonth as supply pressures lessened briefly. This price improvement was offset, however, during the week ended October 23, when an extraordinarily heavy $640 million in new issues was brought to the market. As most of the new issues met only fair receptions, prices of outstanding long-term securities sustained sizable declines. A very heavy buildup in dealer inventories added to market pressures in this sector also. As of October 26, the Blue List of dealers' advertised inventories stood at $847 million, its highest level for the year. These inventories were worked down to $709 million by the end of October, however, and prices generally rose toward the month end amid improved investment demand.